Internal Revenue Service

memorandum

CC:TL-N-2835-89
Brl:CEButterfield

date: FEB - 1 1989

to: District Counsel, Laguna Niguel CC:LN
Attn: Dale A. Raymond

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted] v. Commissioner
T.C. Docket No. [redacted]

This is in response to your request for technical advice by memorandum dated December 21, 1988.

ISSUE

Whether a taxpayer may be required to reflect a theft loss to inventory (accomplished by the substitution of cheaper goods for those invoiced without the knowledge of the taxpayer) in a theft loss deduction, with an offsetting reduction in purchases to reduce the cost of goods sold in the years of substitution.

CONCLUSION

The case law does not support the position taken in this case. The Service has consistently argued that taxpayers suffering thefts to inventory may account for those thefts either through adjustments to cost of goods sold or through a theft loss deduction under I.R.C. § 165. The case law favors reflection of losses to inventory in the inventory itself. Precedence does not support requiring the taxpayer to reflect the loss through a deduction under section 165. Due to the lack of support for the position taken in this case, we recommend that it be conceded in the brief.

FACTS

Taxpayer is an accrual method taxpayer in the business of refining [redacted] into [redacted], [redacted], and [redacted]. In [redacted] taxpayer entered into an agreement with a supplier of [redacted] that for every barrel of [redacted] supplied, the supplier would purchase a barrel of [redacted]. [redacted] costs $3.50 more per barrel than [redacted], and at the time of delivery, and receipt of the [redacted], the amounts of [redacted] and [redacted] were invoiced, and the invoices netted against each other so that the taxpayer only paid the difference in price. The similarities between [redacted] and [redacted], and the amounts involved were such that the substitution was not detected by the taxpayer. We stipulated at trial that the substitutions were made without the taxpayer's knowledge.

LEGAL ANALYSIS

At trial the Respondent took the position that petitioners must value the residual [redacted] at its fair market value rather than at cost. Petitioner uses the cost method of inventory valuation. We accomplished the adjustment by lowering the amount of purchases from cost to value in making the cost of goods sold calculation, thereby decreasing cost of goods sold, and increasing income in the years of substitution. We stated that the taxpayer would be entitled to an offsetting theft loss deduction under section 165 in the year of discovery, which was, at the earliest [redacted], in which the substitution was discovered by our agent on audit, or, arguably, in [redacted], when the taxpayer first acknowledged that the substitution had taken place.

In support of this position, we cited B.C. Cook and Sons, Inc. v. Commissioner, 59 T.C. 516 (1972), supplemental opinion, 65 T.C. 422 (1975), aff'd, 584 F.2d 53 (5th Cir. 1978) and Stahl Speciality Co. v. United States, 558 F. Supp. 1237 (D.C. Mo. 1982), 50 AFTR2d 82-6062, and Rev. Rul. 81-207, 1981-2 C.B. 57. In subsequent conversations, Ms. Raymond also stated that we would cite National Home Products, Inc. v. Commissioner, 71 T.C. 501 (1979).

At the trial Judge [redacted] expressed some reservations about the position we were taking, and suggested that it might be contrary to positions taken before, and contrary to National Home Products. After review of the facts, and the precedents cited in support of our position, we are forced to conclude that Judge [redacted]'s reservations are well founded, and that the case should be conceded at the earliest possible point.

The B.C. Cook case involved a situation in which an employee embezzled funds from his employer through the mechanism of false invoices. After discovering the theft, B.C. Cook was able to recover a portion of the stolen amount, and took a theft loss for the unrecovered portion. We protested that this would result in a double deduction, as the taxpayer had already had the benefit of a reduction to income from the theft loss due to the excessive cost of goods sold figure in the years to which the fraudulent invoices applied, and we attempted to reach the years in which the cost of goods sold was so elevated through the mitigation provisions. The court held, in both Tax Court opinions, that the exclusion of an amount from inventory through elevation of the cost of goods sold figure is not the same animal as a deduction, and may not be reached through the mitigation provisions which apply to deductions.

While B.C. Cook undeniably stands for the proposition that a taxpayer is not entitled to double treatment for the same theft loss, we understand that Coastal did not attempt to account for its losses through any method other than inventory. It did not seek a theft loss deduction, nor have you given us any indication that it intended to do so in some future year. The taxpayer in B.C. Cook received the benefit of a reduction in income in the years of the theft from its inflated cost of goods sold figure. Had B.C. Cook not attempted to take an additional adjustment in the form of a theft loss deduction, we apparently would have made no objection to their treatment of the event. It was the double deduction that we protested in the B.C. Cook cases, and in the Rev. Rul. that followed them. We did not express any disapproval of the treatment of a theft loss in inventory through an inflated cost of goods sold. The adjustment to inventory in an inflated cost of goods sold amounts to an exclusion -- an above the line adjustment to income for the amount stolen. The theft loss deduction is a below the line adjustment for the same amount. B.C. Cook cannot be said to show a preference for one treatment over the other -- it merely stands for the proposition that a taxpayer is not entitled to both.

Taxpayer, on the other hand, cites the line of cases following Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670 (9th Cir. 1980), in which it was held that a taxpayer may adjust cost of goods sold for liquor given to purchasers as a premium, even though the practice was illegal and taxpayer would not be entitled to a business deduction. The Sobel line of cases is even more egregious because in those cases the taxpayers themselves were perpetrating the unlawful reduction to inventory, and were therefore aware of it. The court allowed the liquor given away to be included in cost of goods sold, because it found the premiums were in effect an overall price reduction. We believe these cases lend support to the taxpayer's position. See also Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), nonacq. 1959-1 C.B. 6, acq. 1962-2 C.B. 5, nonacq. 1976-2 C.B. 3.; Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980).

We expressed some inclination to cite National Home Products as support for the adjustment we made. Our reading of that case indicates that it tends rather to support the taxpayer. National Home Products involved a tobacco wholesaler who discovered that nearly $1,000,000 in inventory had been stolen from its warehouses. In computing cost of goods sold for the year of misappropriation, taxpayer sought to write down ending inventory to reflect the stolen amounts. We took the position that no write down was permissible until the possibility of recovery had been exhausted. The Tax Court disagreed, stating that if there were recovery in a later year it would be included in income, and the possibility of future recovery was no reason to require a taxpayer to show large quantities of inventory that it knew were not actually in its warehouses.

In discussing the relationship between inventory adjustments and theft loss deductions, the court stated as follows:

> Respondent seems to recognize that in accounting for a theft of inventory, a taxpayer may either claim the loss occasioned by the shortage as a loss under section 165 or as part of the cost of goods sold. Perhaps the taxpayer is afforded this option -- it would usually make little difference in the computation of taxable income. But the majority of this Court held ... that an adjustment to cost of goods sold is a different animal from a deduction for a loss....
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> Both of the B.C. Cook & Sons, Inc., opinions and the regulations under section 165 recognize that there is a distinction between losses of inventory and other losses and that the proper way to account for inventory losses is through adjustments to cost of goods sold. So, is respondent justified in requiring that an inventory loss must meet the requirements for deductions of section 165 before the cost of goods sold can be adjusted for the loss in inventory in the year it occurs and is discovered? Respondent cites no authority for doing so and we perceive none.

National Home Products, 71 T.C. at 528-529.

Stahl Speciality Corp. lends no more support to the adjustment we made, as that case is merely another in which we took the position that a taxpayer could adjust inventory to reflect a theft loss, or take a deduction under section 165, but not both. In fact, far from supporting the adjustment made in this case, in Stahl Speciality Corp. we argued that the taxpayer was not entitled to a deduction where it had already accounted for the loss in artificially inflated cost of goods sold. In Stahl, therefore, we acknowledged that the theft was properly accounted for by leaving the cost of goods sold figures at their inflated level, and not by a subsequent theft loss deduction.

A few consistent rules may be taken from these cases. We have consistently taken the position that a taxpayer may have a choice between section 165 and an adjustment to inventory to account for a theft from inventory. While we have required that taxpayers choose between the mechanisms, we have never enforced a choice upon them. The courts express a preference for an adjustment to inventory.

This preference is borne out by Accounting Research Bulletin No. 43, Chapter 4, Statements 3, 4 and 5. These statements take the position that inventory should normally be carried at cost. Cost may be based on one of several theories but should be selected to most clearly reflect income. In a situation in which the utility of inventory is reduced below cost, for whatever reason, this lowered utility should be reflected by a write-down within the taxable period. The write-down here referred to, of course, is the diminution of ending inventory, which will have the effect of decreasing income, and giving the taxpayer the benefit of the loss deduction in the period in which the loss occurred. The action we took has just the opposite effect.

If we could not support the position that we had the authority to apply the standards of section 165 to adjustments to inventory under section 471, how much less are we able to justify requiring the deduction to be taken under section 165, and removing the effects of the loss from inventory. All the authority cited supports the opposite proposition. For the reasons given, we find no alternative but to recommend concession at this time.

If we may be of further assistance in this matter, please do not hesitate to contact Ms. Clare E. Butterfield, at (FTS) 566-3442.

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